

ST 99-11

Tax Type: Sales Tax

Issue: Machinery & Equipment Exemption – Manufacturing

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

“XYZ WATER PURIFIERS, INC.”,

Taxpayer

Case No. 96 ST 0000
IBT 0000-0000

Administrative Law Judge
Mary Gilhooly Japlon

RECOMMENDATION FOR DISPOSITION

SYNOPSIS:

This matter comes on for hearing pursuant to the timely protest by “XYZ Water Purifiers, Inc.” (hereinafter “XYZ” or “taxpayer”) of Notices of Tax Liability (“NTL”) No. SF 1900000000000 and NTL No. SF 1900000000001 issued by the Department of Revenue (hereinafter “Department”) on March 21, 1996 for the period of January 1, 1989 through November 30, 1993, and the period of December 1, 1993 through December 31, 1994, respectively.

In lieu of hearing, the parties filed a Statement of Stipulated Facts, and memoranda of law in support of their respective positions.

Following a review of all stipulated evidence and the stipulated facts, as well as of the briefs filed herein, it is recommended that this matter be resolved in favor of the

Department as to the assessment of tax on component parts of equipment used by customers in the energy or power industries. However, I recommend that the balance of the assessment be cancelled, as it is my determination that the component parts are exempt from tax. In addition, it is recommended that penalties be waived based upon reasonable cause.

FINDINGS OF FACT:

1. “XYZ” is engaged in the business of supplying water treatment and purification services to a variety of industrial customers. (Statement of Stipulated Facts, par. 2).
2. “XYZ” designs the equipment it uses to supply the water treatment and purification services. (Statement of Stipulated Facts, par. 4).
3. “XYZ” purchases the component parts of the water treatment and purification equipment from Illinois and non-Illinois vendors. (Statement of Stipulated Facts, par. 5).
4. After “XYZ” purchases the component parts, the component parts are shipped directly by the supplier to a third party for assembly into the water treatment and purification equipment. (Statement of Stipulated Facts, par. 6).
5. In accordance with “XYZ’s” direction, the third party which assembles the component parts into the water treatment and purification equipment ships the assembled equipment to “XYZ’s” customer locations throughout the United States. (Statement of Stipulated Facts, par. 7).
6. “XYZ”, not the customer, then installs the water treatment and purification equipment at the customer site. (Statement of Stipulated Facts, par. 7).

7. “XYZ” does not lease the water treatment and purification equipment to its customers. (Statement of Stipulated Facts, par. 8).
8. Rather, pursuant to a service agreement, “XYZ” retains ownership of the equipment and charges its customers a fee for the water treatment and purification services that it provides using the equipment in issue. (Statement of Stipulated Facts, par. 8).
9. Under rare and exceptional circumstances, “XYZ” sells the water treatment and purification equipment to its customers. (Statement of Stipulated Facts, par. 8).
10. “XYZ” performs water treatment and purification services for customers engaged in a wide variety of industries and businesses. (Statement of Stipulated Facts, par. 10).
11. For example, “XYZ” performs water treatment and purification services for customers engaged in manufacturing silicone chips for use in computer hardware. (Statement of Stipulated Facts, par. 11).
12. The process of manufacturing a silicone chip involves washing the chip to remove impurities. (Statement of Stipulated Facts, par. 11).
13. “XYZ’s” equipment is used in this process to purify the water which, in turn, is used to clean the silicone chip. (Statement of Stipulated Fact, par. 11).
14. The process of manufacturing a silicon chip is a “manufacturing process” as that term is used and defined in Sections 3-5(18) and 3-50 of the Use Tax Act. (35 **ILCS** 105/3-5(18); 35 **ILCS** 105/3-50). (Statement of Stipulated Facts, par. 12).
15. “XYZ’s” customers manufacture silicon chips for wholesale or retail sale. (Statement of Stipulated Facts, par. 12).
16. “XYZ” performs water treatment and purification services for customers engaged in manufacturing paint. (Statement of Stipulated Facts, par. 13).

17. Paint acquires its fluid, liquid form only after it has been mixed with purified water.
(Statement of Stipulated Facts, par. 13).
18. “XYZ’s” equipment is used to purify water before the water is mixed with and incorporated into the paint. (Statement of Stipulated Facts, par. 13).
19. The process of manufacturing paint is a “manufacturing process” as that term is used and defined in Sections 3-5(18) and 3-50 of the Use Tax Act. (35 **ILCS** 105/3-5(18); 35 **ILCS** 105/3-50). (Statement of Stipulated Facts, par. 14).
20. “XYZ’s” customers manufacture paint for wholesale or retail sale. (Statement of Stipulated Facts, par. 14).
21. “XYZ” performs water treatment and purification services for customers engaged in manufacturing water-based pharmaceutical and household products such as cough syrup, mouthwash, liquid detergent and shampoo. (Statement of Stipulated Facts, par. 15).
22. “XYZ’s” equipment is used to purify water that is incorporated into these water-based products. (Statement of Stipulated Facts, par. 15).
23. The process of manufacturing water-based pharmaceutical and household products is a “manufacturing process” as that term is used and defined in Sections 3-5(18) and 3-50 of the Use Tax Act. (35 **ILCS** 105/3-5(18); 335 **ILCS** 105/3-50). (Statement of Stipulated Facts, par. 16).
24. “XYZ’s” customers manufacture pharmaceutical and household products for wholesale or retail sale. (Statement of Stipulated Facts, par. 16).
25. “XYZ” performs water treatment and purification services for customers engaged in manufacturing petroleum products. (Statement of Stipulated Facts, par. 17).

26. To transform crude oil into a marketable product such as gasoline, the crude oil must be broken down into smaller components in a process known as “cracking”.
(Statement of Stipulated Facts, par. 17).
27. The “cracking” is achieved by exposing the crude oil to extreme heat such as steam.
(Statement of Stipulated Facts, par. 17).
28. Running purified water through a boiler generates the steam used in the cracking process. (Statement of Stipulated Facts, par. 17).
29. The water is purified by “XYZ’s” water treatment and purification equipment.
(Statement of Stipulated Facts, par. 17).
30. The process of manufacturing petroleum products is a “manufacturing process” as that term is used and defined in Section 3-5(18) and 3-50 of the Use Tax Act. (35 **ILCS** 105/3-5(18); 35 **ILCS** 105/3-50). (Statement of Stipulated Facts, par. 18).
31. “XYZ’s” customers manufacture petroleum products for wholesale or retail sale.
(Statement of Stipulated Facts, par. 18).
32. “XYZ” performs water treatment and purification services for customers engaged in the energy or power industry. (Statement of Stipulated Facts, par. 19).
33. For example, some of these customers generate electricity for sale. To generate the electricity, purified water is fed into a boiler that produces steam. (Statement of Stipulated Facts, par. 19).
34. The steam runs through a turbine, activates a generator and produces electricity.
(Statement of Stipulated Facts, par. 19).
35. The water that is fed into the boiler is first purified by “XYZ’s” water treatment and purification equipment. (Statement of Stipulated Facts, par. 19).

36. “XYZ’s” water treatment and purification equipment is used for no purpose other than the water treatment and purification purposes described above. (Statement of Stipulated Facts, par. 20).
37. During the periods at issue, “XYZ” self-assessed use tax on the assembled equipment used in supplying water treatment and purification services and remitted this tax to the states in which the equipment was placed into service and used. These states included Texas, California and Louisiana. (Statement of Stipulated Facts, par. 21).
38. The self-assessed use tax was based on the cost price of the assembled water treatment and purification equipment. (Statement of Stipulated Facts, par. 21).
39. During the periods at issue, “XYZ” did not self-assess Illinois Use Tax on the component parts which it purchased and incorporated into the equipment used in supplying water treatment and purification services. (Statement of Stipulated Facts, par. 23).
40. Additionally, “XYZ” concluded that the water treatment and purification equipment qualified for the Illinois manufacturing machinery and equipment exemption. (35 ILCS 120/2-5(14); 35 ILCS 120/2-45). (Statement of Stipulated Facts, par. 23).
41. Pursuant to an audit of “XYZ’s” books and records for the periods at issue, the Department determined that the taxpayer was liable for Illinois Use Tax on the component parts that “XYZ” purchased from Illinois vendors and incorporated into equipment used in supplying water treatment and purification services outside Illinois. (Statement of Stipulated Facts, pars. 24, 25).
42. On March 21, 1996, the Department issued two Notices of Tax Liability to “XYZ” as follows: NTL No. SF-1900000000000 for the period of January 1, 1989 through

November 30, 1993 in the amount of \$56,713, and NTL No. SF-1900000000001 for the period of December 1, 1993 through December 31, 1994 in the amount of \$22,999. (Statement of Stipulated Facts, par. 26; Stip. Ex. G).

CONCLUSIONS OF LAW:

“XYZ Water Purifiers, Inc.” was engaged in the business of supplying water treatment and purification services to various industrial customers during the period of January 1989 through December 1994. Illinois Use Tax was assessed on “XYZ’s” purchase of component parts incorporated into the water treatment and purification equipment pursuant to the Illinois Use Tax Act (35 **ILCS** 105/1 *et seq.*). The taxpayer herein asserts that its purchases of the component parts at issue are exempt from tax by way of the manufacturing and assembly machinery and equipment exemption set forth in section 3-5(18) of the Use Tax Act. The statutory exemption is set forth as follows:

- (18) Manufacturing and assembling machinery and equipment used primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease, whether that sale or lease is made directly by the manufacturer or by some other person, whether the materials used in the process are owned by the manufacturer or by some other person, or whether that sale or lease is made apart from or as an incident to the seller’s engaging in the service occupation of producing machines, tools, dies, jigs, patterns, gauges, or other similar items of no commercial value on special order for a particular purchaser. (35 **ILCS** 105/3-5(18)).

In order to qualify for the manufacturing and assembly machinery and equipment (“M & E”) exemption, three prerequisites must be met. In the case of Van’s Material Company, Inc. v. Department of Revenue, 131 Ill. 2d 196, 203 (1989), the Illinois Supreme Court considered the above-cited statute, and determined that the following

three requisite words or phrases formed the “gist of the statute”: (1) “tangible personal property”; (2) “process of manufacturing or assembling”; and (3) “primarily.”

In its Reply Brief, the Department acknowledges that taxpayer’s purchase of component parts qualifies for the exemption to the extent that purified water produced by the taxpayer’s water treatment and purification equipment is actually incorporated into other articles of tangible personal property. However, to the extent that the treated and/or purified water is not incorporated into tangible personal property, the Department maintains that the law does not allow an exemption from tax for the purchase of the components by the instant taxpayer.

As support for its position that treated and/or purified water not incorporated into the final product is not exempt, the Department relies upon the definition of “manufacturing process” set forth in section 3-50(1), and emphasized as follows:

“Manufacturing process” means the production of an article of tangible personal property, whether the article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by a procedure commonly regarded as manufacturing, processing, fabricating, or refining that *changes some existing material or materials into a material with a different form, use, or name.* (35 ILCS 105/3-50(1)).

Specifically, the Department takes the position that the treated and/or purified water that is used to clean computer chips or cool generators used to generate electricity does not qualify for the exemption because the water is not incorporated into the final product in those instances. According to the Department’s reasoning, there is no change in form, use or name of a material or materials. On the other hand, the Department concedes that in the instances wherein the treated water is incorporated into certain

products, such as mouthwash and paint,¹ a material changes into a material with a different form, use or name. Thus, the water treatment and purification equipment, including component parts, is exempt in those instances.

In effect, by conceding that in the instances wherein water-based tangible personal property is produced the equipment and component parts are exempt, the Department acknowledges that the property at issue constitutes “machinery” or “equipment” in accordance with the statutory and regulatory definitions of such terms. (35 ILCS 105/3-50(3), (4); 86 Ill. Admin. Code ch. I, Sec. 130.330(c)). Therefore, to be considered next is whether the following requisite words or phrases that form the “gist” of the exemption according to Van’s Material Company, Inc., *supra*, are satisfied: tangible personal property, process of manufacturing or assembling, and primarily.

“XYZ” counters in its Reply Brief in Support of Taxpayer’s Protest, that the issue of whether the water is incorporated into a final product is a “red herring”. According to the taxpayer, as long as its customers produce tangible personal property for sale, then its equipment and related parts are used in a manufacturing process, regardless of whether or not purified water is incorporated into the final products.

The taxpayer further asserts that the Department is focusing on the wrong “manufacturing process” when it claims that the exemption does not apply when the treated and/or purified water is not incorporated into tangible personal property. The

¹ In its brief, the Department concedes that the component parts of equipment that purifies water that becomes a constituent of “mouthwash, paint and other tangible personal property” are exempt. In Stipulation paragraph 15, the parties agree that the taxpayer performs water treatment and purification services for customers engaged in manufacturing water-based pharmaceutical and household products such as cough syrup, mouthwash, liquid detergent and shampoo. It is further stipulated that “XYZ’s” equipment is used to purify water that is incorporated into these water-based products. Even though the Department only mentions “mouthwash, paint and other personal property” in its brief, I will assume that the products mentioned in stipulation paragraph 15 are meant to be included in the phrase “other personal property” as additional water-based products.

purification and/or treatment of water is not the manufacturing process that is at issue, according to “XYZ”. Rather, the manufacturing process under discussion is the production by “XYZ’s” customers of silicon chips, shampoo and petroleum products, for example. The fact that the taxpayer, rather than the manufacturer of these products, owns the equipment is not relevant as section 3-5(18) of the Use Tax Act specifically provides for this possibility. According to “XYZ”, the relevant inquiry is whether tangible personal property is produced for sale.

The statute describes a manufacturing process as the production of tangible personal property, whether it be a finished product, or an article for use in the process of manufacturing a different article of tangible personal property. There must, however, be a change in the material to transform it into a material with a different form, use or name.

As the court noted in Van’s Material Co. v. Dept. of Revenue, 131 Ill. 2d at 207-208,

Ordinarily, the article so manufactured takes a different form or at least subserves a different purpose from the original materials and usually it is given a different name. Raw materials may be, and often are, subjected to successive processes of manufacture, each one of which is complete in itself but several of which may be required to make the final product. (Kohlsaat & Co., 255 Ill. 271, 272 (1912), quoting Tide-Water Oil Co. v. United States, 171 U.S. 210, 216 (1898).

Section 3-50 of the Use Tax Act provides as follows:

In relation to a recognized integrated business composed of a series of operations that collectively constitute manufacturing, or individually constitute manufacturing operations, the manufacturing process commences with the first operation or stage of production in the series and does not end until the completion of the final product in the last operation or stage of production in the series. (35 **ILCS** 105/3-50(1)).

To be determined, therefore, is whether component parts of equipment used to purify water that is ultimately used in the production of computer chips, electricity and petroleum products are exempt from Use Tax as manufacturing and assembling

machinery and equipment. As the taxpayer points out, the manufacturing process at issue is not water purification. Rather, the purification and/or treatment of water is but one process that takes place before the final products are manufactured.

The parties have stipulated that the process of manufacturing silicon chips is a “manufacturing process” as that term is used and defined in sections 3-5(18) and 3-50 of the Use Tax Act. Likewise, the parties stipulated that the process of manufacturing petroleum products is a “manufacturing process” as that term is used and defined in the pertinent statutory provisions. The Department distinguishes between those manufacturing processes wherein the purified water is incorporated into the final product and those processes wherein the treated water is not incorporated, but used to either cleanse the chips or produce steam to crack crude oil. However, the Department offers no satisfactory explanation for this distinction, nor cites any supporting case, statutory or regulatory law. Based upon the stipulated facts, the processes of manufacturing silicon chips and manufacturing petroleum products are by statutory definition “manufacturing processes”. The separate and distinct processes which are necessary to arrive at the final manufactured products are collectively part of the manufacturing process. Thus, the component parts of machinery and equipment used to cleanse computer chips and to purify water used to produce steam to crack crude oil are exempt in that these are processes necessary to the manufacture of silicon chips and petroleum products.

The pertinent regulation, 86 Ill. Admin. Code, ch. I, Sec. 130.330, sets forth by way of illustration certain activities that are generally considered to constitute an exempt use. For example, subsection (d)(3)(A) provides that the use of machinery or equipment to effect a direct and immediate physical change upon the tangible personal property to

be sold is generally considered to be an exempt use. It was stipulated that the process of manufacturing a silicon chip involves washing the chip to remove impurities. Common sense dictates that the water purified by the equipment at issue effects a direct and immediate physical change upon the chip. Prior to washing, the impurities prevent it from being used in computer hardware. The cleansed chip, however, allows the manufacturing process to continue toward the production of the final product.

The act of purifying water that is converted to steam to crack crude oil is an even stronger illustration of equipment effecting a direct and immediate physical change upon the property to be sold. The parties stipulated that in order to transform crude oil into a marketable product such as gasoline, the crude oil must be broken down into smaller components by a process known as “cracking”. Water purified by the equipment at issue is converted to steam which is used to crack the crude oil. There is no question but that the purification equipment effects a direct and immediate physical change upon the crude oil by “cracking” it by means of steam derived from heated purified water.

It is well known that “normally private letter rulings have no precedential effect.” (Union Electric Co. v. Department of Revenue, 136 Ill.2d 385, 400 (1990)). However, there are several private letter rulings that support the taxpayer’s position and buttress the foregoing analysis. Therefore, while not precedent setting, the letter rulings offer guidance as they disclose the Department’s interpretation of its regulations during the pertinent period. (Union Electric, *supra*).

In PLR 97-007 (March 5, 1997), the Department responded to a ruling request concerning machinery and equipment that was used in a soybean crushing plant wherein the final product was soybean oil and meal. The Department responded that equipment

used in the cleaning and drying of the soybeans was exempt. The Department noted that the equipment must effect a direct and immediate physical change upon the property to be sold, and said changes must result from the process in question and be substantial and significant. In the same ruling letter, the Department determined that a cooling tower system and a boiler would also qualify for the exemption, as long as the water in the cooling tower was utilized primarily to maintain exempt machinery and equipment, as opposed to being utilized for general cooling purposes. Likewise, the boiler would be exempt if used primarily to create steam used to effect a direct change upon the product being produced, as opposed to general heating purposes. As applied herein, the equipment purifies water used to cleanse silicon chips for use in computer hardware, and purifies water that is converted to steam to crack crude oil. These changes are significant and required by the respective manufacturing processes.²

PLR 92-0084 (February 7, 1992) was written in response to a request for a ruling regarding whether the machinery and equipment exemption would apply to a water cooling tower system. The taxpayer represented that the equipment is required to keep its molding injection and other production line equipment at the proper temperature to process goods through the line. The Department responded that although the facts related by the taxpayer are not extensive, based upon the information provided, if the cooling tower is used primarily to maintain equipment used primarily in the manufacture of tangible personal property for sale or lease (i.e., exempt equipment), then the cooling tower qualifies for the exemption.

² The relevant statute does not speak of any requisite that the machinery or equipment be essential to the manufacturing process in order to qualify for the exemption. Furthermore, the stipulation does not state on its face that the purification of water is necessary to the manufacturing processes at issue. However, it is

In another private ruling letter, 93-0426 (July 29, 1993), the Department determined that a boiler used primarily to produce steam used to heat and effect a direct change upon the product being manufactured was exempt. The Department found that the boiler contributed to and was an integral part of the taxpayer's manufacturing process. In the instant case, the purification of the water certainly contributed to the manufacture of computer chips, as well as the production of petroleum products.

PLR 94-0070 (March 28, 1994) concerned whether source pencils and dosimeters used by a taxpayer in a sterilization process were exempt machinery and equipment. Based upon the facts provided by the taxpayer, the Department determined that the dosimeters did not qualify for exempt status as they were consumable strips that merely recorded information. However, the source pencils were considered to be exempt as they were essential to an integrated manufacturing process. The source pencils were lifted from a pool of water and irradiated certain products that were ultimately sold. After the sterilization of these products (such as plastic creamer cups and lids, medicine bottles, surgical gloves, intravenous solution tubing sets, scalpels and needles), they were returned to the customer for further processing, or shipment and sale. In the instant case, water purified by the component parts of taxpayer's equipment is used to assist in the manufacture of products ultimately sold, and is essential to said process.

The parties stipulated that the taxpayer performs water treatment and purification services for customers engaged in the energy or power industry. The parties did not stipulate, however, that the production of electricity, for example, is a manufacturing process. The taxpayer argues in its brief that its customers that are in the power or energy

certainly a fair inference when reading the stipulation that the purification of water is an integral part of each manufacturing process.

industry are engaged in a manufacturing process. “XYZ” also cites cases that hold that gaseous oxygen constitutes tangible personal property because of its characteristics. The taxpayer argues that since natural gas is so similar to gaseous oxygen, it likewise should be considered tangible personal property. Thus, according to the taxpayer, the water treatment and purification equipment is used in a manufacturing process with respect to its natural gas industry customers.

The record is seriously lacking in factual matter concerning the taxpayer’s water treatment and purification services performed for customers engaged in the energy or power industry. The stipulation simply states that some of the customers generate electricity for sale. There is then a description of how purified water is turned into steam which runs through a turbine, activates a generator and produces electricity. There is no indication whatsoever as to the identity of the other customers in the energy or power industry, and there are no facts to support any claim that these energy or power industry customers “manufacture” tangible personal property for retail sale, as required by statute. Furthermore, electricity has long been considered by the courts to be a commodity, bought and sold like other personal property, but it is intangible personal property. (People Gas Light Co. v. Ames, 359 Ill. 152 (1934); People v. Menages, 367 Ill. 330 (1937)). In order to qualify for the M&E exemption, tangible personal property must be manufactured or assembled. Thus, given the minimal amount of facts presented, as well as the fact that intangible personal property does not qualify, the taxpayer has failed to prove its entitlement to the exemption in this area.

Once it is determined that manufacturing processes are taking place, it is necessary to consider whether the water treatment and purification equipment is used

primarily in these manufacturing processes. Not only does there have to be a manufacturing process, but also the equipment must be used primarily in such process. “Primarily” is defined in section 130.330(d)(1) of the regulations (86 Ill. Admin. Code, ch. I, Sec. 130.330(d)(1)) as over 50 percent use in an exempt manner. The parties stipulated in paragraph 20 of the Statement of Stipulated Facts that the water treatment and purification equipment was used for no purpose other than the water treatment and purification purposes described in the stipulation. Thus, as the taxpayer points out in its Reply Brief, if it is determined that the equipment (and therefore, component parts as well) qualifies for the M&E exemption, then it follows that said equipment is used primarily in an exempt manner since it is stipulated that it was used for no other purposes. As it is my determination that manufacturing processes are taking place when the equipment is used to treat water used to clean computer chips, and to purify water used to produce steam to crack crude oil, it is also my determination that this is the primary use of the equipment based upon the stipulation filed herein.

The taxpayer argues additionally, that because it never received actual possession of the component parts in Illinois, it never exercised any right or control over the parts in Illinois. Therefore, they are not subject to Illinois Use Tax. The Department counters that the taxpayer’s definition of the word “use” is too restrictive. The taxpayer purchased the tangible personal property from Illinois vendors. The parts are shipped by the supplier to a third party for assembly into the water treatment and purification equipment. The third party assembles the equipment in accordance with the taxpayer’s directions, and then ships it to taxpayer’s customer locations throughout the United States.

The taxpayer's act of having the parts removed from Illinois to another state subsequent to purchase constitutes "use" within the definition set forth in section 2 of the User Tax Act:

"Use" means the exercise by any person of any right or power over tangible personal property incident to the ownership of that property, ... (35 ILCS 105/2).

From the facts presented, I concur with the Department that the taxpayer's purchase of tangible personal property from Illinois vendors, and subsequent act of directing the supplier to ship the parts out of state for assembly into the water treatment and purification equipment is sufficient to constitute a taxable use. Certainly, by its actions, the taxpayer exercised power over the property incident to its ownership.

There is abundant case law to the effect that "[a] person claiming an exemption from taxation has the burden of proving clearly that he comes within the statutory exemption. Such exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation." (United Air Lines, Inc. v. Johnson, 84 Ill.2d 446, 455 (1981)). The presumption is against the intent to exempt the property from taxation. (United Air Lines, 84 Ill.2d at 456). It is my determination that based upon the facts stipulated to by the parties and the statutory and case law applicable herein, the taxpayer has proved its entitlement to the M&E exemption in all areas, other than in the area of water treatment and purification services to customers engaged in the energy or power industry.

However, while the taxpayer may have proven that it is entitled to the exemption in the areas other than the energy and power industries, the record lacks any evidence that differentiates the various industries engaged in by the taxpayer's customers.

Therefore, it is not possible to apportion the assessment among those industries that purchased component parts used to treat water that is used for purposes determined to be exempt, as opposed to the treatment of water used in the nonexempt energy and power industries. Given the absence of necessary proof in the record, I must uphold the assessment as issued, with no distinction between purchases of component parts by any of the taxpayer's customers.

The taxpayer urges that if it is determined that the component parts at issue do not qualify for the exemption, that the assessed penalty in the amount of \$6,956 be waived based upon reasonable cause. "XYZ" asserts that it qualifies for waiver of penalties based upon reasonable cause as it exercised ordinary business care and prudence in determining its Illinois tax liability. As the taxable period herein is prior to the effective date of the Illinois Uniform Penalty and Interest Act, said statutory provision is not applicable to the instant cause. However, section 5 of the Retailers' Occupation Tax ("ROT") Act (35 ILCS 120/1 et seq.) speaks to the issue of waiver of penalties due to reasonable cause. Said statutory section is incorporated into the Use Tax Act via section 12 thereof (35 ILCS 105/12). Section 5 of the ROT Act provides in pertinent part as follows:

However, where the failure to file any tax return required under this Act ... is shown to be unintentional and nonfraudulent and has not occurred in the 2 years immediately preceding the failure to file on the prescribed date or is due to other reasonable cause the penalties imposed by this Act shall not apply.

There is stipulated evidence that "XYZ" filed use tax returns, and self-assessed and paid use tax in those states wherein the water treatment and purification equipment was used after assembly (i.e., Texas, California and Louisiana). The taxpayer assumed

that no Illinois Use Tax was due on the component parts as they were to be assembled into equipment used outside Illinois and on which use tax was self-assessed. In addition, as it is the taxpayer's posture that the component parts would be exempt from Illinois Use Tax due to the M&E exemption, "XYZ" offers this position as justification for its failure to file and pay, and therefore, as additional support for its proposal of waiver of penalties.

Given the fact that the taxpayer filed returns and self-assessed and paid use tax in those states wherein the assembled equipment was ultimately delivered and used, it appears that the taxpayer's failure to file Illinois Use Tax returns and pay the tax due was nonfraudulent. It cannot be said that the failure to file and pay was unintentional, however. As the taxpayer chose to file returns and pay tax to other states, it realized that tax was most certainly due somewhere. The taxpayer made a deliberate decision to pay other states, rather than Illinois. However, due to the fact that no fraud was involved, and accepting as reasonable taxpayer's legal arguments regarding the application of the Illinois exemptions to the machinery and equipment, it is my determination that penalties should be waived based upon reasonable cause.

RECOMMENDATION:

Based upon the foregoing, it is my recommendation that Notice of Tax Liability Nos. SF 1900000000000 and 19000000000001 issued by the Department be finalized as issued. Penalties assessed are waived based upon reasonable cause.

8/19/1999

Mary Japlon
Administrative Law Judge